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Backgrounder

REGULATION OF FINANCIAL INSTITUTIONS: OWNERSHIP POLICY

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EXECUTIVE SUMMARY

In a policy paper released in December 1986, the Minister of State for Finance set out a comprehensive set of proposals for reforming the regulatory structure of Canada's financial sector. A major element among those proposals was a new ownership policy designed to sever financial-commercial links and to ensure that larger financial institutions are widely held. More specifically, under the new policy, commercially-linked investors would be barred from establishing a financial company or acquiring an existing one with capital in excess of $50 million. Financial companies with capital in excess of $750 million would be required to have at least 35% of their voting shares publicly traded. In addition, new acquisitions in such companies would be limited to 10% and existing holdings in excess of 10% would be capped at that level.

Arguments in favour of such ownership restrictions give prominence to the aim of ensuring a safe and sound financial system, and hinge largely on two propositions. These are (a) closely held ownership and financial-commercial links expand significantly the opportunities for conflicts of interest and self-dealing abuses that can undermine confidence in the financial system and (b) ownership restrictions are the surest means of dealing with the concerns identified in (a). An additional argument for banning financial-commercial links stems from concerns that combinations of commercial and financial interests could give rise to huge conglomerates with overwhelming economic and political power.

Those opposed to ownership restrictions stress the importance of competition and efficiency in financial markets. They view the financial support that commercial backers can provide to financial affiliates as an important source of strength and stability for the latter. They point out that problems arising from conflicts of interest and self-dealing are not unique to financial-commercial links or to closely held institutions, and argue that these problems can be controlled with less disruption and cost through specific regulations than an outright ban on certain ownership structures. They view ownership restrictions as having

anti-competitive effects in financial markets and as being at best irrelevant as a policy to contain corporate concentration in the economy at large. They also argue that the proposed ownership restrictions may induce commercially linked institutions to seek opportunities abroad or refuge under a provincial charter at home.

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INTRODUCTION AND BACKGROUND

The 1980s have been a decade of unprecedented change in financial markets. A wide range of new financial products -- index futures, option contracts, securitized mortgages, swaps, NIFs, RUFs, TIGRs, and a host of other instruments with exotic names and acronyms -- has enormously enhanced the ability of financial markets to accommodate the needs of lenders and borrowers, and has blurred distinctions between the different financial sectors: banking, trust, insurance and securities dealing -- the so-called four pillars of finance. Developments in telecommunications and computer technology, which have made these financial innovations possible, have also largely eliminated geographic barriers to financial transactions, integrating separate regional and national markets into a global, round-the-clock market for financial services.

Within Canada, through a spate of mergers and acquisitions, corporate reorganizations and business failures, the structure of the financial industry has been substantially transformed. There are fewer independent players today than ten years ago, and the role of conglomerate groups has grown more pronounced. Yet, at the same time, competition in financial services has been growing more intense, as banks, trust companies, credit unions, insurers and securities dealers have been branching aggressively beyond their core activities to challenge each other's markets. Trust companies make commercial and consumer loans, insurance companies issue short term annuities that are close substitutes for bank certificates of deposit, banks deal in securities, and securities dealers

offer their customers cheque-writing services. In 1986, The Laurentian Group Corp. opened the doors to its Carrefour financier La Laurentienne in Montreal, a centre where a customer can deposit money, negotiate a loan, sell stock, buy insurance, and arrange trust services: Canada's first financial supermarket. Other conglomerate groups are bound to follow suit.

In the wake of these market changes, legislators have been scrambling to adapt existing laws to the requirements of the new environment. At the federal level, the Government released a discussion paper in April 1985, setting out a comprehensive set of proposals for the reform of the regulatory framework for financial institutions. Following reviews of that discussion paper by two Parliamentary committees and responses to it by the private sector, the proposals in the paper were revised and reissued on 16 December 1986 in a policy paper entitled New Directions for the Financial Sector (hereinafter referred to as the Blue Paper).

The thrust of the Blue Paper was two-fold. It sought to increase competition in financial services by expanding the powers of financial institutions to engage in cross-pillar activities, either directly or (mainly) through affiliated companies. And it sought to contain abuses in the industry through a strengthened supervisory system, enhanced corporate governance, and restrictions on the conduct and structure of financial institutions. Among the latter restrictions are rules designed to prevent links between financial and commercial companies and to ensure that at least larger financial institutions are widely held. Of all the measures proposed in the Blue Paper, these restrictions have raised the greatest controversy.

The part of the Paper dealing with the supervisory system has already been enacted with the establishment, in July 1987, of the Office of the Superintendent of Financial Institutions (OSFI) and the grant of increased powers of supervision and direction given to OSFI and to the Canada Deposit Insurance Corporation, the agency charged with insuring deposits at chartered banks and trust companies. In July 1987, a first step was also taken in the expansion of powers of financial institutions, with the authorization for federally regulated financial institutions to own securities dealers. The remaining sections of the Paper await

legislative action. Progress towards their enactment has been much slower than anticipated when the Paper was first tabled.

The delay has been largely due to opposition generated by the proposals to sever financial-commercial links and restrict closely held ownership of financial institutions. Generally, domestically owned chartered banks, which hitherto have been widely held and without commercial ties, favour diffused ownership of financial institutions and separation between finance and commerce. Non-bank financial institutions, many of which already have close ownership links with commercial firms, are generally opposed to the proposed ownership restrictions. Also strongly opposed are the provinces, none of which bars ownership links between provincially regulated financial and non-financial firms or insists that ownership of financial institutions must be diffused.

The next section of this paper outlines the main elements of the proposed ownership policy. The paper then reviews the arguments on both sides of the debate, with the third section presenting the case in favour of the proposed restrictions, and the fourth presenting the case against them.

PROPOSED OWNERSHIP POLICY

The ownership policy set out in the Blue Paper is designed to restrict financial-commercial links and to encourage widely held ownership of financial institutions. To these ends, it proposes the following measures:

- investors with significant commercial interests will be prohibited from:

  a) incorporating a finance company;
  b) acquiring ownership positions exceeding 10% in a finance company with capital in excess of $50 million.
  c) increasing ownership positions in a company with capital in excess of $50 million, if they already hold a more than 10% interest.

- commercially linked financial companies with capital in excess of $50 million will be required to have at least 35% of their voting shares publicly traded and widely held (meaning that no single shareholder may own more than 10%).

- Even finance companies without commercial links will be required to have at least 35% of their voting shares publicly traded and widely held if they have a capital base exceeding $750 million. In addition, new acquisitions in such companies will be limited to 10% and existing holdings in excess of 10% will be capped at that level. If the company is a bank, shareholders with an interest above 10% will be prohibited from acquiring any additional shares, so that as the bank grows it will become widely held.

For purposes of the ownership policy, the Paper defines a commercial interest or commercial company as a corporation "engaged in the production and distribution of goods and non-financial services, or financial services on an unregulated basis" (p. 19). Individual investors would be deemed commercially linked, or considered to have a "significant commercial interest," if they held a 10% ownership interest in a commercial company. To exempt from these ownership rules investors with commercial interests small relative to their financial interests, shareholders would not be deemed commercially linked if their commercial interests were 5% or less of their total interests in financial institutions.

ARGUMENTS FAVOURING OWNERSHIP RESTRICTIONS

A. The Public Interest in a Safe and Sound Financial System

The case for maintaining financial institutions separate from commercial ones begins with the premise that financial institutions are not only distinct but also "special" in ways that invite -- indeed, require -- public protection and patronage.(1) Their role in the economy

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(1) See for example, E. Gerald Corrigan, "Are Banks Special?" Annual Report 1982, Federal Reserve Bank of Minneapolis; and statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing and Urban Affairs of the United States Senate, 13 September 1983.

is pivotal. As financial intermediaries, bringing savers and borrowers together, they facilitate the allocation of capital to productive uses. As operators of the national payments system, handling millions of cheques and credit items daily, they make possible at low cost the huge volume of transactions on which a modern economy depends. They are the custodians of the bulk of the liquid savings of Canadians. And they constitute the transmission belt through which the monetary policy of the central bank affects the economy at large.

The extensive use of credit on which our financial system depends, the fiduciary responsibilities of the institutions that comprise that system, the financial counselling services that these institutions provide -- all require a high degree of public confidence and trust if they are to be properly performed.

Confidence in the financial system is important in another respect as well. The system operates on a so-called "fractional reserve" basis, meaning that the assets held by financial institutions in the form of cash are only a small fraction of their total liabilities. Normally, this poses no problem, since deposit withdrawals are usually a small and fairly predictable portion of total liabilities. An unanticipated increase in withdrawals, however, could place even a sound institution at risk of default, because the need to convert its assets into cash at short notice could so depress their value as to leave the institution insolvent. The fear of non-convertibility can spread from one institution to others, leading in extreme cases of panic to a general run on deposit institutions and financial collapse.

Public policy has long recognized the unique and fragile nature of the financial system, and has sought to shelter it through a variety of measures. Thus, the Bank of Canada, as lender of last resort, stands ready to extend liquidity support to any member of the Canadian Payments Association (which includes all chartered banks, most major trust companies, and credit union centrals) which finds itself under liquidity pressure. The Canada Deposit Insurance Corporation insures fully deposits in member financial institutions up to $60,000 per account, thereby reducing the incentive for preemptive deposit withdrawals. Legislative

provisions stipulate strict capital and licensing requirements for starting a financial institution, and impose tough restrictions on the type of investments and business activities in which financial institutions may engage. The Office of the Superintendent of Financial Institutions at the federal level and corresponding supervisory authorities in the provinces monitor closely the operations of these institutions and enjoy wide powers to intervene when they deem the conduct of an institution to be unsound or imprudent. This network of safeguards reflects the strong public interest in the stability and safety of the financial system.

Granting all the foregoing concerning the role and nature of financial institutions, why should legislation bar ownership links between financial and commercial firms or require that financial firms be widely held? Proponents of such restrictions offer two basic reasons: a) to minimize conflicts of interest and self-dealing abuses, which undermine the impartiality of credit allocation and may threaten the solvency of financial firms, and b) to limit the concentration of corporate and, derivatively, political power.

B. Conflicts of Interest

Conflicts of interest arise whenever a firm is serving two or more competing interests and is able to favour one over the other(s). A securities firm, for example, that performs the dual role of investment advisor and securities underwriter may find itself counselling clients on securities that it is trying to market. Similarly, a firm that acts as both a trustee and financial intermediary may be in a position to use the trust funds it manages to promote its intermediary activities, to the possible detriment of the trust beneficiaries. It has been claimed, for instance, that in the U.S., where commercial banking and trustee services are combined within single firms, it was an "almost universal practice" until the late 1960s to use "trust department commissions for the acquisition of deposits from brokers, to the principal advantage of the commercial department and the bank as a whole."(2)

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(2) Edward S. Herman, Conflicts of Interest: Commercial Bank Trust Departments, The Twentieth Century Fund, New York, 1975, p. 8.

Conflicts of interest are found in virtually every line of business. It is clear, however, that the more diversified the interests of an institution become, the greater the likelihood that the institution will find itself in situations where two or more of these interests are at variance. Financial firms are in the business of providing financial services -- lending, insurance, underwriting, money management, trusteeships -- to other, primarily non-financial, firms and to individuals. A potential conflict of interest arises whenever the client of a financial firm is a competitor of one of the firm's affiliates. An illustration of such a situation was provided by Bernard Ghert, former Chief Executive Officer of the large Toronto real estate firm Cadillac Fairview Corporation, to the House of Commons Standing Committee on Finance, Trade and Economic Affairs. Mr. Ghert testified that he knew of an instance where,

> if the witnesses were required to testify under oath, they would have to tell you of a financial institution which had instructions from senior executives of the parent non-financial company to refuse loans to one of its competitors.(3)

Commingling of financial and commercial firms may bias credit decisions in other respects as well. A financial institution may more readily extend credit to a borrower if that borrower is a client of the financial institution's affiliate than if he is not. Indeed, the financial institution may condition its lending on the borrower's willingness to patronize its affiliated business.

Beyond its anti-competitive aspects, such behaviour raises two additional concerns. First, it undermines confidence in the impartiality of the financial institutions, with deleterious effects on the effectiveness of the financial system as a whole. As the Bank of Canada Governor John W. Crow has stressed:

> Maintaining public confidence goes beyond narrowing the chances that financial institutions will run into solvency or liquidity problems and ensuring that any problems do not spread. Users of financial services

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(3) Canada, House of Commons, Standing Committee on Finance, Trade and Economic Affairs, Minutes of Proceedings and Evidence, 1st Session, 33rd Parliament, 23 September 1985, 68:6.

> must also have confidence in the fairness, the impartiality, of financial institutions. The string of insider trading charges in the United States serves to remind us that one of the major sources of corporate financing in our financial system -- the stock market -- will not fulfill the role expected of it if investors come to perceive that the dice are loaded against them. Likewise financial institutions must also be seen to be acting impartially in their decisions in extending loans.(4)

Second, when the impartiality of a financial institution's credit-granting decisions is impaired, that institution's balance sheet is also likely to suffer. Clients who, if objectively assessed, would not qualify for a loan may be accommodated, while credit-worthy customers may be denied credit. The result would be a poor loan portfolio, with the further implication that the institution's earnings would be depressed and its solvency at risk.

An additional, and probably greater, threat to the solvency of a financial institution linked to commercial interests arises from the wide scope that such a link provides for self-dealing transactions harmful to the financial institution. Examples would include the extension of credit to the non-financial affiliate at subsidized rates, the purchase of assets at prices exceeding market value or investments at unfavourable terms in projects sponsored by the affiliated company. While self-dealing transactions are common in business, they raise particularly serious concerns when financial institutions are involved, owing to the unique structure of the financial industry. In short, this is an industry that operates with "other people's money." The leverage (i.e., the assets to equity ratio) of deposit-taking institutions exceeds twenty; that of non-financial institutions rarely exceeds three.(5) Several failures of trust companies in recent years have been attributed to self-dealing transactions involving real estate purchases at prices substantially above market value.

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(4) Notes for a Luncheon Address at the 71st Annual Meeting of the Investment Dealers Association of Canada, Ottawa, 9 June 1987.

(5) Economic Council of Canada, A Framework for Financial Regulation, Supply and Services Canada, Ottawa, 1987, p. 50.

The incentive for a financial institution to provide its affiliate with cash injections is particularly tempting when the affiliate finds itself in financial straits. If the financial institution yields to the temptation, it loses to the extent that the expected returns from the cash advance are not commensurate with the associated risk. But if it resists, it may also suffer, for the failure of its affiliate is bound to have an adverse effect on how its own stability and strength are perceived by the market.

The potential for oppressive self-dealing transactions is widely viewed as being greater when an institution is closely held. This is because, as argued by the Ontario Task Force on Financial Institutions, closely held ownership provides "an environment in which depositors' interests, managerial interests and the interests of minority shareholders can be subordinated easily to the interests of the dominant shareholder."(6) A study by the Economic Council of Canada found that nearly half of the failures of financial institutions in Canada between 1980 and 1985 were associated with "questionable practices"; and all these cases in which questionable practices were present involved closely held financial firms.(7)

C. Corporate Concentration

The discussion thus far has dealt almost exclusively with the possible effects of financial-commercial links on the impartiality of the credit allocation process and the solvency of financial institutions, and, by extension, on the stability and safety of the financial system as a whole. A concern of a different order is the effect of such links on the concentration of power, political as well as economic, in our society.

As already noted in an earlier section, financial institutions enjoy a unique, privileged position in our economy. They control most of the country's liquid wealth and play a dominant role in the process

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(6) Ontario Task Force on Financial Institutions, Final Report, Toronto, December 1985, p. 57.

(7) Economic Council of Canada (1987), Chapter 4.

through which capital is allocated to different economic sectors and activities. If allowed to combine with non-financial economic interests, the resulting conglomerates could be vested with overwhelming competitive advantages over their non-conglomerate rivals. They would enjoy assured and cheap access to credit -- partly through the availability of government-backed deposit insurance and an implicit government guarantee against failure if the financial institution is large enough -- while being able to deny it to their competitors. They would be able to extend financing to their customers at favourable terms and attract new business by making credit conditional on such a change in business loyalty. There would be a tendency for conglomerates to grow over time and for the concentration of economic resources to increase. The inevitable consequences of such a trend, would be a narrowing of consumer choice, higher product prices, and greater volatility of financial markets, as experience with the stock market -- increasingly dominated by large institutional investors -- shows.

Corporate concentration has several dimensions. It can refer to the relative position of large enterprises in the economy (aggregate concentration), the relative position of large enterprises in the provision of specific goods or services (market concentration) or the extent to which shares of publicly traded companies are widely or closely held (ownership concentration).(8) Canada displays high levels of concentration in each of these dimensions, a situation which according to one authority at least may be unique among nations.(9) Moreover, empirical evidence suggests that over the past two decades or so these concentration levels have been on the rise.(10)

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(8) See R.S. Khemani, "The Dimensions of Corporate Concentration in Canada," in R.S. Khemani, D.M. Shapiro and W.T. Stanbury, (eds.), Mergers, Corporate Concentration and Power in Canada, The Institute for Research on Public Policy, Halifax, 1988, p. 17-38.

(9) Ibid.

(10) Ibid. and William Krause and Jack Lothian, "Measures of Canada's Level of Corporate Concentration," Canadian Economic Observer, Statistics Canada, January 1989, p. 3.14-3.31.

Potentially adverse effects on competition, and hence on resource allocation and economic efficiency, are one source of concern about these high levels of corporate concentration. Another source is the potential threat that large concentrations of resources pose to the integrity and effectiveness of the democratic process. Large corporations and corporate groups can have a disproportionate influence on public policy. This derives from a host of advantages, including their possession of huge economic resources, which can be used to influence public opinion, political parties, and policymakers; their effective organizational structures and specialized skills, which enable them to coordinate their resources in the promotion of their objectives; and their access to key players in the political field on crucial occasions.(11) It is a reasonable expectation that corporations possessing such power will use it to further their interests, and these will not always coincide with the interests of the public at large.

In a properly functioning democratic political system, representative institutions can be relied upon to ensure that when special interests collide with the public interest, the latter will prevail. However, when concentration of corporate power grows sufficiently large, the ability of representative institutions to check it is reduced, and democratic control over public policy is to that extent diminished. Many observers of our current situation feel that we may have already progressed too far in that direction. The following statement by Bernard Ghert captures well their concerns about the threat of a laisser-faire approach to commercial-financial linkages:

> So down the road, perhaps within a decade in the absence of any effective controls over conglomerate ownership, we could see the emergence of a dozen or fewer very powerful groups, spanning financial and industrial sectors. In view of some more recent activity, it might be only three or four very, very powerful groups. They would yield enormous power in a country the size of Canada. That power could be sufficient to influence significantly the political process itself and ultimately our political freedoms.

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(11) W.T. Stanbury, "Corporate Power and Political Influence," in Khemani et al (1988), p. 393-452.

> The process of concentration has already started. The emergence of conglomerates in which non-financial enterprises dominate financial institutions has been the phenomenon of the Eighties. What is alarming is that it is a continuing process, without any perceived will on the part of government to check it. Worse, it is probably irreversible.
>
> We may wake up in a few years to the fact that the concentration of economic power in Canada has got out of hand. Will government then have the means or the will to intervene to stop this process, let alone reverse it?(12)

ARGUMENTS AGAINST OWNERSHIP RESTRICTIONS

The basic case against the ownership restrictions proposed in the December 1986 Blue Paper is that the need for them has not been demonstrated. Indeed, it can be argued that the proposed restrictions will have effects opposite to those claimed by their supporters: by diverting attention from the real sources of conflict of interest, they may exacerbate incidents of credit bias and self-dealing abuses; and by denying commercial investors entry into financial markets, they may hamper competition and foster concentration in the provision of financial services. They have already led to federal-provincial squabbling over jurisdictional turf, and may result in reduced federal control over financial markets if institutions resort to provincial chartering as a way of circumventing them. They may have the unintended consequence of favouring foreign over domestic investors. Finally, they may be based on a dated notion of the role and nature of financial institutions. We begin this section of the paper with an examination of this last question.

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(12) Address to the Vancouver Board of Trade and The University of British Columbia Alumni Association, Vancouver, 10 April 1986. For additional illustrations of similar views, see Diane Francis, Controlling Interest: Who Owns Canada? Macmillan Co., Toronto, 1986, and W.T. Stanbury (1988).

A. Are Financial Institutions Special?

In at least one sense -- a trivial sense perhaps -- financial institutions are special: they are the key players in our payments and monetary systems. But are they unique in the functions that they perform? And -- a question equally important for regulatory policy -- are the consequences of failure in financial markets so much more serious than failures in other sectors of the economy as to warrant greater public concern and intervention? While the prevailing view would give an affirmative answer to both of these questions, there is a school of economics that sees financial services as a "business much like any other business" which, given an appropriate incentive structure, "requires little different regulation than other business."(13) What follows is a brief review of this school's position.

The fear that financial institutions are inherently fragile and that the failure of one may easily snowball into a fully-fledged financial crisis is at the base of much of the regulatory structure that girds our financial markets and the source of a good many calls for additional regulatory measures. Yet, there is little warrant for it.

Financial institutions fail for the same reasons as other enterprises: essentially, bad luck and bad management. Because their liabilities are generally more liquid than their assets, banks and other deposit-taking institutions may be more vulnerable to liquidity pressures than other institutions are, but the likelihood that such pressures alone will founder an otherwise solvent institution is exceedingly remote. This is first of all because the existence of deposit insurance, by assuring depositors that their funds are safe even if their bank goes under, has all but removed the possibility of panic-induced withdrawals of deposit funds and hence of bank runs. And second, because, with appropriate intervention from the central bank, the adverse effects of bank runs can be contained. We shall consider the effect of a bank run first on a single bank and then on the banking system as a whole.

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(13) George G. Kaufman, "Federal Bank Regulatory Policy: Comment on Kareken," <u>Journal of Business</u>, Vol. 59:1, January 1986, p. 77.

If the bank experiencing a run is solvent, then other banks or private lenders would normally be prepared to advance it the funds necessary to prevent a "fire sale" of its assets that might lead to its collapse. In the absence of private lending, the central bank would advance the necessary funds, for that is precisely its role as lender of last resort. If the ailing bank is in fact insolvent, then it ought to be closed down in order to protect its remaining assets and to deter other banks from taking excessive risks.

The effects of a bank run on the financial system generally will depend on what depositors do with the funds they withdraw from the bank under pressure. They have essentially two choices. The most likely is that they will redeposit the funds withdrawn in another financial intermediary. In that case, the contraction of the bank experiencing a cash drain is exactly offset by an expansion somewhere else in the financial system, so the system as a whole remains unaffected. Alternatively, if the depositors' confidence in the financial system as a whole is sufficiently impaired, they may decide to keep their withdrawals in the form of currency. In that case, there would tend to be a contraction in the financial system which might lead to a contraction in the real economy as well, resulting from actions by pressurized banks to liquidate outstanding loans and curb new lending. Such an outcome, however, is rare. It is also within the power of the Bank of Canada to prevent by injecting sufficient reserves into the banking system to compensate for the leakages into currency holdings.(14)

The historical record shows that the foregoing discussion is not just empty theorizing. Even before the establishment of the Bank of Canada in 1935, instances of bank failures leading to general financial panic and financial crisis were extremely rare. They have been completely absent in the more than 50 years since then. Recent experience with the failure of two regional banks in the mid-1980s confirms that our financial

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(14) George Kaufman, <u>ibid.</u>, on which this discussion is based, mentions a third option: the purchase of securities. But this is really a variant of one of the other two, for the sellers of securities must themselves either deposit their receipts (i.e., choice A) or hold on to the currency (choice B).

system is much more robust than most observers believed at the time. Concern about the presumed adverse consequences of a bank failure on other banks and on the Canadian economy generally, had led the federal government in March 1985 to sponsor a financial support package designed to keep the troubled Alberta-based Canadian Commercial Bank afloat. In the event, the support package proved inadequate, and CCB was closed down six months later. At the same time, a second Alberta-based bank, the Northland, also collapsed. No bank had previously failed in Canada since the failure of Home Bank in 1923. Yet, the impact of these two simultaneous bank failures was mostly political. Financial markets were undisturbed. The exchange rate of the Canadian dollar was unaffected. Bank stocks actually rose.

In retrospect, this outcome should not have come as a surprise. In sophisticated financial markets, it makes no sense for participants to lose confidence in all institutions just because a few prove unsound or deficient. And in the unlikely event that such a thing should happen, judicious intervention by the central bank can contain the damage to the sound institutions. The fear of contagion in financial markets is therefore not a sound basis for differentiating financial intermediaries from other institutions.

In other relevant respects, failures of financial institutions raise less cause for public concern than do the failures of other business firms. The owners of failed financial institutions lose, of course, but so do owners of other firms that fail. The employees and customers of failed financial institutions may also be adversely affected, but probably less so than employees and customers of businesses in other sectors of the economy. This is because financial products tend to be very homogeneous across financial institutions. The skills of employees in the financial industry are therefore readily transferable, and customers of a failed financial institution can readily be accommodated by another. In addition, a financial institution that fails is usually absorbed by another, and hence continuity of employment and customer contacts can be maintained in most cases.(15)

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(15) The arguments in this paragraph have been made by George Benston with respect to banks, but can validly be extended to other financial institutions. See George J. Benston, "Federal Regulation of Banking: Analysis and Policy Recommendations," Journal of Bank Research, 13:4, Winter 1983.

Professor George Kaufman attributes the inordinate fear of bank failures that underpins much of the regulatory framework of financial institutions to the experience of the Great Depression, an unrepresentative experience made even less relevant today with the establishment of deposit insurance and better appreciation of the role of the central bank as the lender of last resort. Historical legacy also explains the persistence of the notion that the role that financial institutions perform is unique. It is a notion increasingly difficult to maintain.

The technological revolution that has been blurring distinctions between the various financial sectors in recent years has also been chipping away at the wall between finance and commerce. Banking, Lord Rothschild once wrote, "consists essentially of facilitating the movement of money from Point A, where it is, to Point B where it is needed."(16) Its basic functions are to keep track of deposit claims, monitor the use of assets purchased with those claims, and maintain a system of accounts for recording transfers of wealth evidenced by deposit balances.(17) Walter Wriston's description of banking as a branch of the information business is therefore very apt.(18) It follows that any firm that is good at storing, processing and transmitting information can also be good at providing financial services. Reuter's, IBM, and AT&T, according to Wriston, will be among the banks' major competitors in the 1990s. Each one of these companies has already branched into financial services.*

They are not alone. With computer and communication costs tumbling over the past decade, barriers to entry into financial services have also been falling sharply. Many non-financial firms are discovering

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(16) Lord Rothschild, Meditations of a Broomstick, Collins, London, 1977.

(17) See Eugene Fama, "Banking in the Theory of Finance," Journal of Monetary Economics, 1:6, January 1980, p. 39-57.

(18) Walter B. Wriston, Risk and Other Four-Letter Words, Harper and Row, New York, 1986, p. 135. Water Wriston is former Chairman of Citicorp of New York, the largest U.S.-based commercial bank.

* Bell Canada Enterprises (BCE) is about to join them, as revealed by the agreement announced 5 March to acquire Montreal Trustco Inc., the parent company of Montreal Trust, the fifth largest trust company in Canada.

that, at little extra cost, they can reduce their reliance on commercial banks and make better use of their cash balances by converting their treasury departments into "in-house banks." Recent examples of such in-house banks include AB Fortus, a subsidiary of the Swedish car manufacturer Volvo, BP Finance Industries, of British Petroleum, ICI Finance, of Britain's Imperial Chemical Industries, Nissan International Finance, of the Japanese automaker Nissan, PSA International, of Peugeot, and Panasonic Finance, of Japan's Matsushita Electric.[19]

These finance subsidiaries borrow directly in financial markets by issuing bonds and commercial paper, and lend or invest surplus funds to maximize returns. While for the most part they confine their activities to satisfying the financial needs of their affiliates, there is nothing in principle to prevent them from offering their services to other customers as well. For some, such an expansion may well take place as they mature, as has in fact occurred with the captive financial subsidiaries of such manufacturing firms as General Motors, Ford, and General Electric. The point is that these in-house banks are engaging in activities traditionally associated with banking and finance. So are such retailing firms as Sears, K Mart, and J.C. Penney which, either directly or through affiliates, accept deposits, make loans, buy and sell securities, and provide insurance services. And indeed so are gas stations that issue credit cards, grocery stores that cash cheques, and leasing companies that lend money. To quote Walter Wriston once again, "today, in financial services, you can't tell the players even with a scorecard."[20] Detection is not likely to get any easier with time.

B. Concentrated Ownership and Corporate Conduct

Opposition to closely held financial institutions stems primarily from concerns that the controlling shareholders will use their position to enrich themselves at the expense of the institution. They may,

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(19) See David Fairbank, "Multinationals Open In-House Banks," Dun's Business Month, May 1986, p. 54-56; and Joanna Pitman, "In-House Finance Threat to Banks," Euromoney, October 1987, p. 55-58.

(20) Wriston (1986), p. 72.

for instance, take excessive risks with the institution's deposits or, more directly, they may engage in self-dealing transactions at terms detrimental to the institution. It is not clear, however, in either logic or experience, that such problems are more serious with closely held than widely held companies. On the other hand, imposing legislated limits on ownership does entail clear economic costs, resulting from a reduced ability of shareholders to control management and from lower competition.

Conflicts of interest and self-dealing problems do not arise from ownership links only. They can arise with anyone who is in a position to influence the behaviour of an institution. This would include not only major shareholders, but also senior officers and directors of the institution. It is well known, for instance, that the boards of directors of chartered banks are largely composed of the chief executive officers of the banks' major borrowing firms. The Royal Commission on Corporate Concentration (better known as the Bryce Commission), reporting in 1978, expressed concern about this situation in the following terms:

> Inevitably this creates the possibility of a conflict of interest, collective as well as individual, where the directors' obligations to the bank may clash with their duties elsewhere. Regardless of the degree of integrity and good faith that exists, in such a situation circumstances may cloud judgment.(21)

It is at least arguable -- and hence significant in an industry where perception is crucial -- that some of the huge loans to companies such as Massey Ferguson and Dome Petroleum, which have plagued Canada's banks in the 1980s, would not have been made but for the directorship connections between these companies and the lending banks. Further, according to evidence presented by Hal Jackman of Empire Life to the Standing Committee on Finance and Economic Affairs of the Ontario Legislative Assembly, of the more than a score of failures of financial institutions since the mid-1960s, only the failure of the Greymac-Seaway group of companies (in 1983) could be attributed to self-dealing abuses by owners.

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(21) Canada, The Royal Commission on Corporate Concentration, Report, Minister of Supply and Services, Ottawa, 1978, p. 254.

On the other hand, self-dealing by officers and directors has been identified as the cause of failure in several cases.(22)

This record illustrates that dispersion of stock ownership is not a cure for self-dealing abuses. Diffused ownership normally entails control of the company by management rather than by a dominant shareholder. The problem of self-dealing does not thereby go away; its focus merely shifts from the dominant shareholder to management. Even if the ability to engage in abusive self-dealing thereby declines, the incentive to do so rises because the costs imposed on the institution will be borne mostly by others rather than the person involved in the transaction. It is difficult to say in advance which effect would dominate, and whether therefore dispersion of stock ownership would constrain or worsen the problem of self-dealing abuses.

In the economic literature generally, the existence of a major shareholder in a firm is viewed as a positive influence on the firm's conduct and performance. Most large corporations today are run by a professional management rather than by their owners, and a key issue for any professionally managed corporation is how to ensure that managers, who in both theory and in law are acting as agents of the shareholders, do in fact serve the shareholders' interests. The primary goal of shareholders is maximization of the value of the firm -- which is the aim also consistent with the most efficient use of the assets that the firm controls. Managers may give priority to other objectives, including greater security of tenure and pecuniary rewards for themselves. The presence of a major shareholder facilitates monitoring and control of management, thereby reducing the scope for managerial behaviour at variance with shareholders' interests. In the performance of this monitoring and control role, the major shareholder also provides a service to minority shareholders and other creditors (including depositors in the case of deposit-taking institutions) who also have a clear interest in the protection of the company's worth.

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(22) Cited in Thomas J. Courchene, "Re-regulating the Canadian Financial Sector: The Ownership Controversy," in Khemani _et al_ (1988), p. 548.

In a widely held corporation, the problem of aligning management's behaviour with the interests of shareholders is much more difficult, for shareholders in such a corporation lack incentive to monitor management closely. This is so for two reasons. First, monitoring is costly, but the shareholder doing it receives only a small fraction of the benefits it may yield. Second, the information generated from such monitoring may be useless anyway unless one is able to organize enough shareholder support to override management in a proxy fight, which is rarely the case.

One means for disciplining management in widely held corporations is the market for corporate control, where outsiders who believe they can make better use of a corporation's assets bid to acquire control of that corporation. Ownership need not actually change hands for the beneficial effects of the market for corporate control to be realized: the threat of takeover can stimulate management to manage more efficiently. If the transfer of control is barred through legal restrictions on individual holdings, this market does not operate. Management then has much greater scope for pursuing its own objectives, even if they are at variance with shareholder interests.

While there is no consensus on the significance of the market for corporate control, a growing body of evidence suggests that it works in the way expected. One type of evidence derives from studies on the effect of mergers and acquisitions on the market value of the firms involved.(23) In virtually all cases, these studies show that the combined market value of the companies rises significantly, indicating that in the judgment of market participants the anticipated reorganization will result in improved performance. While in some cases the higher value may result from greater monopoly power rather than from greater efficiency in the use of the acquired assets, the evidence does not support the view that the creation of monopoly power is the source of the value gain.(24)

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(23) See B. Espen Eckbo, "The Market for Corporate Control: Policy Issues and Capital Market Evidence," in Khemani _et al_ (1988), p. 143-225.

(24) _Ibid._, p. 172.

More direct evidence on this question tends to confirm the inferences drawn from stock market studies. A recent U.S. study on the effect of ownership structure on managerial performance compared banks in states that prohibit corporate acquisitions of banks with banks in states where acquisitions are permitted. Using excessive expenditures on salaries (expenditures in excess of the profit-maximizing level) as a proxy for managerial inefficiency, the study found that expenditures for salaries were significantly higher in nonacquisition than in acquisition states. Moreover, within the nonacquisition states, where immunity from takeover provides management with scope to consume perquisites, the study found that higher levels of ownership concentration tended to be associated with lower levels of salary expenditures. Within the acquisition states, no consumption of perquisites was found.(25) These findings lend support to Eckbo's conclusion based on stock market studies, namely that "government regulations which make it more difficult to transact in the corporate control market are likely to result in a socially suboptimal allocation of corporate resources without any clearly offsetting benefits."(26)

C. Cross-Ownership and Conflicts of Interest

As noted previously, conflicts of interest are common within the finance industry and even within the same financial institution. Combinations of financial with commercial firms raise no conflicts of an order or magnitude that does not already exist within purely financial groups. And the added competition and choice that they bring to financial markets lessen the potential for abuse that conflicts of interest create.

Some of the thorniest interest conflicts arise when investment and commercial banking are combined, as has been happening in Canada

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(25) James A. Brickley and Christopher M. James, "The Takeover Market, Corporate Board Composition, and Ownership Structure: The Case of Banking," Journal of Law and Economics, Vol. XXX, # 1 April 1987, p. 161-180.

(26) Eckbo (1988), p. 206.

with the recent acquisitions of Canada's major securities firms by Canada's major chartered banks. The securities industry depends crucially on bank credit to finance inventories and loans to clients: a bank with its own securities subsidiary would not be a disinterested party in a decision involving the extension of credit to a competing securities firm. The bank's securities subsidiary would also find its impartiality tested whenever it had to underwrite the debt of a corporation to which its bank parent was a major lender or if it had to underwrite any of its parent's loans portfolio. According to Stanley Beck, Chairman of the Ontario Securities Commission, controlling possible abuses in such contexts is much more difficult than would be the case if the securities firm were owned by an industrial company.(27)

It is instructive to note that in the U.S., where commercial banks and securities firms are not allowed to mix, supporters of continued separation between these two financial sectors use arguments essentially identical to those used in Canada by those who wish to keep finance separate from commerce. Thus, for example, the Investment Company Institute, the national association of the U.S. investment companies industry, argues that the combination of commercial banking and securities activities in the late 1920s led to widespread consumer abuses which in turn resulted in a "massive loss of public confidence" in the banking system. Permitting such combinations today, ICI says, would raise similar problems. To illustrate:

> A bank that has a securities affiliate which can securitize and underwrite the bank's loans has an enormous incentive to use this distribution channel to dispose of low-quality loans. Moreover, in an effort to generate fee income from loan organizations, a bank might lower its lending standards on the assumption that it will be able to sell such sub-standard loans to investors through its securities affiliate. Likewise, a bank might lower its lending standards in order to generate a sufficient quantity of loans to keep its

(27) Cited in Courchene (1988), p. 556.

> securities affiliate's distribution channels fully occupied.(28)

Others have argued that allowing banks and securities firms to mix would bias the credit allocation process, lead to a concentrated securities industry, and undermine the stability of the banking system, by taking banks into activities that are much riskier than traditional banking. Canada's Investment Dealers Association used to make similar arguments prior to 1986, when their position on the issue of combining commercial with investment banking changed from being opposed to being in favour.

That arguments about conflicts of interest can be self-serving does not of course deny the fact that conflicts of interest exist and that the possibility of abuse is real. But there are ways of dealing with the potential for abuse short of barring ownership links between sectors.(29)

Competition is one of them. Nobel-laureate economist George Stigler has branded competition "the consumer's patron saint." Competitive markets allow consumers to protect themselves from conflicts of interest by avoiding business with firms they do not fully trust and patronizing firms free of ties that create interest conflicts or firms that manage their affairs with sufficient transparency and trustiness to inspire confidence. A policy that restricted commercially linked investors from engaging in financial activities would have the effect of restricting competition and consumer choice in financial services, and thereby would tend to increase the potential for conflict of interest abuse.

Competition is also related to a second means for controlling conflict of interest abuses: the internal policies of financial institutions. The success of an institution in a competitive environment depends significantly on its reputation for integrity and fair dealing.

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(28) Unites States, House of Representatives, Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, Hearings, 100th Congress, 2nd Session, 2 and 9 February 1988, p. 113.

(29) See United States General Accounting Office, Bank Powers: Issues Related to Repeal of the Glass-Steagall Act, Washington, D.C., January 1988, p. 51-52.

The institutions themselves therefore have a strong economic incentive to institute internal policies for handling conflicts of interest in ways that reassure both customers and creditors. These may include disclosure of relevant information, the establishment of "Chinese walls" to insulate certain activities from others, review of sensitive transactions by independent committees, and other measures. In the limit, when the perceived interest conflicts are too great relative to the benefits expected from engaging in a particular activity, the institution may decide to forgo that activity altogether. Thus Royal Trust has announced that it does not intend to go into the brokerage industry because "it is too difficult to be an asset manager and also be a broker."(30)

The importance of reputation or good will to an institution rises with the value of the assets whose worth hinges on that reputation. This suggests that a financial institution that is part of a corporate group has less incentive to engage in oppressive or imprudent transactions than has a comparable stand-alone financial firm, because any damage to its reputation would impair not only its own worth but that of the whole conglomerate group of which it is a part. Thus, for a financial institution, having a major non-financial affiliate is similar to having its own capital increased: it encourages integrity and prudence in its operations by raising the stakes that ride on those operations.

In this light, the de minimis test of the proposed ownership policy seems perverse. It would exempt from the ownership rules commercially linked investments in the financial industry, provided the non-financial interests of the investor are small enough. This raises all the conflict of interest possibilities that the policy was supposedly designed to prevent, while the self-interested restraints to the abuse of those conflicts are minimal. If the aim of the ownership policy is to secure the safety and soundness of the financial system, it would be better to permit financial-commercial links only in cases where the commercial interests are large relative to the financial interests.

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(30) Cited in D.G. McFetridge, "The Effects of Concentrated Ownership and Cross-Ownership on the Stability and Efficiency of the Financial System," in Khemani (1988), p. 351.

A third control on the abuse of conflicts of interest consists of the laws and regulations that make abuse illegal and prescribe procedures that financial institutions must adopt to identify and deal with conflicts of interest. An effective supervisory system can ensure that these laws and regulations are adhered to and that abusive practices are minimized.

As a general principle, a legal ban on any voluntary business arrangements should be viewed as a last resort, to be adopted only if available means of dealing with the risks of such arrangements are not effective and only if the benefits from the ban exceed the costs. In the case of commercial-financial ownership links, this test has simply not been met. As argued above, problems stemming from conflicts of interest and self-dealing transactions are at least as difficult in relationships between different financial sectors as in relationships between financial and commercial interests. If appropriate controls can be devised to deal with the former, it should also be possible to devise controls to deal with the latter.

The experience of other countries is instructive on this score as well. Within market-based economies at least, restrictions on diversification across financial sectors -- particularly between commercial and investment banking -- are more common than restrictions on links between financial and commercial interests. According to testimony by Edward Johnson, Vice-President of Power Financial Corporation, before the Senate Banking Committee, Norway may be the only developed country imposing a ban on commercial-financial links.(31)

Integration between the financial and the real sectors is not unusual in other countries. Here is how the Report of the Macdonald Royal Commission describes the relationship between banks and industry in Japan:

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(31) Canada, Standing Senate Committee on Banking, Trade and Commerce, Proceedings, 2nd Session, 33rd Parliament, 16 June 1987, 28:20.

> Large firms are organized into banking groups in association with one or another of the 13 largest commercial banks. Each banking group has a trading company that acts as a go-between, importing goods and services for sale in Japan and exporting the group's products. Credit is extended with relative ease to the banking group's affiliates. The bank can help nurse a troubled firm back to health by assuming management of the debtor's finances and imposing compromises on other creditors within the group. Ties between the bank and its corporate customers are increased by the bank's ability to invest in shares in non-financial companies, by cross-directorship, and by the temporary assignment of bank employees to the businesses of bank customers. The close affiliation between the banks and industrial companies provides a focal point around which the capital market can design reorganization plans. It is also reputed to serve as a means of reducing the cost of capital to industrial firms.(32)

In Germany, the ties between banks and industry are even closer. In that country, there is no legal separation between investment and commercial banking or between banking and non-financial activities. As a result, Germany's grossbanken -- its six major banks which dominate commercial banking -- in addition to the core activity of commercial lending, are also engaged in securities underwriting and trading. Bank ownership of equity shares in industrial firms is common: the Macdonald Royal Commission reported that in 1980 banks controlled 70% of the shares of the 425 largest corporations in Germany.

Even in the U.S., where financial markets have been most heavily regulated and legislation has attempted to separate banking -- but not financial services generally -- from commerce, investors have been finding ways around the legislative barriers, and so-called "nonbank banks" account for a very large and rapidly increasing share of financial sector business. Many of these nonbank banks began as "captive" financial companies, serving the needs of their parent, and then went on to outgrow that role. Today, nonbanks are major competitors in the provision of the widest range of financial services (commercial, consumer and mortgage lending,

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(32) Canada, Royal Commission on the Economic Union and Development Prospects for Canada, Report: Volume Two, Minister of Supply and Services, Ottawa, 1985, p. 172.

leasing, insurance, brokerage and underwriting, cash management, credit cards, and cheque writing) and they rival deposit-taking institutions in the market for credit claims, accepting deposits directly or operating money market funds which are close substitutes for deposits.

In Canada, investors with commercial interests have been a major force of new competition and innovation in financial markets over the past two decades. Chartered banks continue to dominate financial markets, but their position is less overwhelming than it used to be two decades ago, and they have been forced to adapt by expanding the range of financial products that they provide and increasing the hours during which they remain open for business. The competition that has been the main impetus behind these changes has been provided in large measure by aggressive trust companies linked to commercial interests. The financial backing that these trust companies enjoy through their commercial links has been a major source of stability and strength as they challenge the chartered banks for new customers and markets. The new, widely held chartered banks that were established over this period have mostly disappeared either through failure (as with the Canadian Commercial Bank and the Northland Bank) or mergers arranged to forestall failure (the Unity Bank, the Continental, the Mercantile, and the Bank of B.C.).

It follows that if Canadian non-financial firms and investors with non-financial interests are barred from entering financial markets, a potentially major new source of competition is closed off. With financial markets becoming increasingly global, new competition may of course come from abroad. The irony is that this foreign competition will probably be commercially linked, as the recent application by American Express to establish a Schedule B bank vividly illustrates. In other words, a policy that restricted commercial interests from diversifying into financial services would deny domestic investors opportunities to participate in financial markets while making it easier for foreign investors to gain shares in those markets. Canadian investors as a result might be forced to seek opportunities outside Canada.

There is some evidence that this is already happening. On 6 February 1989, Royal Trustco Ltd., Canada's largest trust company,

announced a U.S. $212 million agreement to purchase Pacific First Financial Corp. of Tacoma, Washington. In making the announcement, Royal also said that it is focusing its future growth in the U.S. partly because of restrictions it faces on expansion in Canada because of its ownership ties to Brascan Limited, a diversified holding company with interests in natural resources and consumer products, in addition to financial services.(33) Professor Courchene has speculated that, under the ownership policy proposed in the December 1986 Blue Paper, domestic companies might be encouraged to move their head offices abroad in order to improve their investment opportunities here at home. "For example," he writes, "might Power Financial not increase both its international and domestic flexibility by relocating its head office to, say Belgium, and then seeking reentry into Canada as a Schedule B bank?"(34)

D. Cross-Ownership and Corporate Concentration

By most measures of concentration, Canada's financial markets are highly concentrated and they are dominated by the six major Schedule A banks. Restricting the ability of non-financial institutions to enter the financial industry would tend to make the domination of the industry by incumbent institutions easier and to perpetuate market concentration in the provision of financial services. On this score, the ownership policy of the Blue Paper is clearly anticompetitive and pro-bigness.

Are restrictions on commingling of finance with commerce necessary in order to prevent excessive concentration at the aggregate level? Although the recent spate of takeovers has once again heightened concerns about the level of corporate concentration in Canada, it is not clear that current concentration levels are a serious problem either for the economy or public policy generally. The last time this issue was thoroughly examined (by the Bryce Commission in the late 1970s), the conclusion drawn was that, while economic concentration was higher in

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(33) Jacquie McNish, "Royal Trustco to Buy U.S. Financial Firm," Globe and Mail (Toronto), 7 February 1989, p. B1.

(34) Courchene (1988), p. 529.

Canada than elsewhere, Canadian firms tended to be small by world standards and that on the whole Canada would benefit from increased corporate concentration.(35) Although there is some indication that aggregate concentration has increased since the Commission reported, the evidence is not unambiguous. The Statistics Canada study cited earlier (footnote 10 on page 11), which showed increases in aggregate concentration over the past decade based on the relative importance of the largest 25 enterprises, would have shown a decrease in aggregate concentration had the top 100 enterprises been used as the measure.

At any rate, even if corporate concentration is a problem in Canada, it is not a financial-commercial combination problem. It is possible to have enterprises consisting of financial and commercial firms and still be relatively small. Many such enterprises are. And it is possible to be a giant conglomerate that raises concerns about excessive economic and political power without being a financial-commercial enterprise. In fact, most large Canadian conglomerates are not.

It follows that if corporate concentration is a problem, barring financial-commercial links is not the solution. If anything, such a policy may make the situation worse. This point has been made most effectively by Thomas F. Huertas, Vice President of Citicorp/Citibank of New York:

> Any law that restricts entry confers wealth on the people owning the entities that are protected from competition, and this tends to create a constituency in favor of the law. The current system of financial regulation is no exception. Regulation protects specialized financial firms from competition and increases their profit-making potential. Consequently, specialized firms have the incentive to reinvest some of the excess profits generated by regulation to lobby for a continuation of the very system of regulation that generates those excess profits. In this sense, excessive political power is far more likely to result

(35) Canada, The Royal Commission on Corporate Concentration (1978), p. 406.

from restricting entry, rather than from allowing entry, into financial services.(36)

E. Federal-Provincial Issues

The ownership restrictions proposed in the December 1986 Blue Paper would place federal policy at odds with policies in every one of the ten provinces. No province bars the entry of commercially-linked investors into the financial industry or insists that financial institutions be widely held. In recent measures or proposals to reform their laws on financial institutions, Quebec, Ontario and B.C., the provinces accounting for the bulk of financial business activity in Canada, confirmed their support for a regulatory environment which does not discriminate against commercial investors or closely held firms. These provinces see ownership restrictions as creating unnecessary barriers to entry into the financial sector and making it more difficult for indigenous institutions to develop and survive against international competition.

The divergence on ownership policy between Ottawa and the provinces creates two possibilities, neither of them desirable. One is that commercially-linked investors wishing to participate in financial markets would seek to do so through provincial charters. In that event, the intent of the ownership restrictions would be frustrated. As argued by John Evans, President of the Trust Companies Association of Canada, "we could see the emergence of a segregated financial services industry with the widely-held banks and foreign institutions regulated by Ottawa, and closely-held and commercially linked non-banks regulated by the provinces."(37) In other words, the end result of the proposed ownership restrictions might be not a reduction in the participation of commercial

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(36) Thomas Huertas, "Can Banking and Commerce Mix?" in Catherine England and Thomas Huertas (eds.) The Financial Services Revolution -- Policy Directions for the Future, Kluwer Academic Publishers, Boston, 1988, p. 294.

(37) John Evans, "Bank Domination and Corporate Concentration: The Impact of Federal Financial Services Policy," paper presented to the Insight Conference, 3 March 1988.

interests in Canada's financial markets, but participation in a form outside the regulatory control of the federal authorities.

The second possibility is that the federal government, in order to prevent a circumvention of its policy as just suggested, might seek to expand its authority over non-bank financial institutions by defining "banking business" -- over which the federal Parliament has exclusive control -- sufficiently broadly to encompass activities now performed by non-bank financial institutions. Whether the courts would sanction such a gambit is at this point moot. What is certain is that it would lead to a major federal-provincial row.

Of course, these two possibilities are not mutually exclusive. In fact, the most likely outcome of the proposed ownership restrictions may well be a reduction in federal control over domestic financial institutions <u>and</u> increased confrontation between Ottawa and the provinces over jurisdictional turf.

CONCLUSION

Disagreements over what constitutes an appropriate ownership policy for financial institutions stem largely from different perspectives on how the financial system works.

Supporters of ownership restrictions tend to view the financial system as very fragile, with a high potential for individual failures to escalate into widespread panics and financial crises. They therefore put great store on the safety of financial institutions, and are prepared to limit competition and ownership options to ensure this end.

Opponents of ownership restrictions tend to see the financial system as basically robust, and financial crises as very rare events. They generally associate more openness with greater strength, for easier access to financial markets makes it easier for new firms to challenge existing ones that might otherwise grow lethargic. And though the new competition may well prove fatal for some of the incumbents, it also ensures that surviving companies are lean and responsive to consumer wants.

Supporters of ownership restrictions tend to see in the commingling of financial with commercial firms a dangerous increase in the potential for conflict of interest abuses; opponents of restrictions tend to see increased opportunity for financial institutions to diversify their activities, thereby enhancing the productivity of their assets and reducing their risk exposure.

Supporters of restrictions tend to view controlling shareholders of financial institutions as the focus of fraudulent and abusive practices; opponents see them as generally beneficial forces, their ownership stake providing them with the otherwise absent incentive to monitor management and promote prudent conduct.

One side views ownership restrictions as a necessary bulwark to excessive concentration of corporate power in Canada; the other sees such restrictions as a serious impediment to competition in financial markets and irrelevant to aggregate concentration in the economy.

Clearly, the ownership policy of the Blue Paper is inspired mainly by the first vision. It therefore seeks to prevent closely held ownership of financial institutions and to constrain ownership links between financial and non-financial firms. At the same time, it recognizes at least some validity to the second vision by allowing relatively small financial firms to remain closely held and to acquire commercial links. The problem with this particular compromise is that the firms thereby exempted from the ownership rules would be precisely those most likely to be associated with the type of questionable conduct -- excessive risk-taking, conflict of interest abuses, unbalanced or fraudulent self-dealing transactions -- that the ownership policy is designed to prevent. It is a telling fact, for instance, that none of the financial firms that failed in Canada over the past two decades would have been affected by the ownership policy proposed in the Blue Paper. The Paper itself recognizes that ownership restrictions are no substitute for other protective measures, including a strengthened supervisory system and enhanced corporate governance. The question that needs to be answered is whether, once such other measures have been adopted, ownership restrictions are desirable at all.

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